

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT [REDACTED] POSTF-151962-01
[REDACTED]

date: FEB - 7 2002

to: [REDACTED]
Team Manager, Group [REDACTED]

from: Area Counsel
(Heavy Manufacturing, Construction and Transportation: [REDACTED])

subject: [REDACTED]
Section 1231 Gain from the Sale of Partnership Property
[REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your request for assistance with respect to the issue described below. This memorandum should not be cited as precedent.

Issue

Whether the reduction of debt by a creditor in connection with the sale of the property encumbered by the debt to a third party is discharge of indebtedness income or gain from the sale or exchange of property?

Facts

[REDACTED] or the partnership) is a general partnership that started business on [REDACTED]. The partnership's principal business activity was to develop a piece of real estate in [REDACTED] known as [REDACTED]. The partners are as follows:

[REDACTED]	%
[REDACTED]	%
[REDACTED]	%
[REDACTED]	%

Prior to the formation of the partnership, [REDACTED] was owned by [REDACTED] a partnership controlled by [REDACTED]

██████████ and his family. ██████████ purchased ██████████ on ██████████. Under the terms of the sale, the partnership paid approximately \$██████████ in direct payments to the seller, and taxes and fees related to the property. In addition, the partnership assumed an existing \$██████████ mortgage debt collateralized by the property. This debt, together with an additional \$██████████ loan, was refinanced by a nonrecourse loan from ██████████, (██████████) secured by a nonrecourse mortgage on the property. The mortgagor was ██████████. Although it is not entirely clear, it appears that the additional funds were also applied to pay for expenses relating to the purchase of the property. Therefore, the partnership's total basis in the property at the time of purchase was \$██████████, of which \$██████████ was financed by ██████████.

The \$██████████ payment by ██████████ was financed by a capital contribution from ██████████ in his capacity as general and indirect limited partner of ██████████. ██████████ obtained the funds from a line of credit he secured from ██████████'s ██████████. The total line of credit available was \$██████████.

On ██████████, ██████████ refinanced its indebtedness to ██████████. In connection with the refinancing, it secured an additional loan of \$██████████. The loan was budgeted to be applied as follow:

Reimburse Partner's Equity:	\$██████████
Real Estate Taxes	\$██████████
Predevelopment soft costs	\$██████████
Interest Reserve	\$██████████

The recourse of the lender on this indebtedness was limited to the mortgaged property, including ██████████ as well as other unidentified future collateral.

██████████ did not make payments on this indebtedness and was substantially in default prior to ██████████.

The partnership claims that between ██████████ and ██████████ it incurred additional development costs, presumably financed by the additional ██████████ loan, which were capitalized and included in its basis in ██████████. You are still in the process of verifying this representation. We express no opinion as to whether the partnership's basis in the property is in excess of \$██████████.

In ██████████, an agreement was reached for the transfer of the property and related debt to a two-tiered partnership structure. The contemplated transaction was described in a Waiver and Consent

Agreement dated [REDACTED] between [REDACTED] and other banks participating in the [REDACTED] loans, as follows.

The [REDACTED] affiliates would enter into certain transactions with [REDACTED] (the Land Purchaser) and [REDACTED] (the Loan Purchaser) and [REDACTED] (the Development Entity) with respect to the loans made by [REDACTED] consolidated in the principal amount of \$ [REDACTED] as well as a separate \$ [REDACTED] loan by [REDACTED] to [REDACTED] for accrued and unpaid interest.

Specifically, [REDACTED] agreed to reduce the aggregate principal amount of the mortgage loans and to discharge the interest loan, in exchange for the Loan Purchaser buying the notes, obligations, claims and other rights from [REDACTED]. [REDACTED] would sell to the Land Purchaser the real property and other assets constituting the collateral for the reduced mortgage. [REDACTED] will acquire an equity interest in the Land Purchaser and the development entity will arrange for a [REDACTED] affiliate to receive an equity interest in the Development Entity.

[REDACTED] had additionally loaned \$ [REDACTED] to [REDACTED] to fund real estate taxes, secured by a second mortgage on the [REDACTED] commercial unit as well as the [REDACTED] property. As part of the contemplated series of transactions, [REDACTED] agreed to release its lien on the [REDACTED] property and accept full payment of such loans by the receipt of [REDACTED] prior to [REDACTED].

On [REDACTED], [REDACTED] was formed. [REDACTED] The general partner was [REDACTED], and the limited partners were [REDACTED] and [REDACTED]. [REDACTED] contributed \$ [REDACTED] and [REDACTED] contributed \$ [REDACTED]. [REDACTED] made no capital contributions, but he pledged to perform certain services to the partnership and a number of provisions guaranteed his performance, and specified certain reimbursement obligations to the partnership, as well as the termination of his partnership interest, for failure to perform. The interests of the partners [REDACTED], [REDACTED], and [REDACTED] were [REDACTED]%, [REDACTED]%, and [REDACTED]%, respectively.

The Partnership Agreement provided that the purpose for the partnership was to purchase, develop, and sell the [REDACTED] property. The partners acknowledged that contemporaneously with the execution of the partnership agreement, the general partner ([REDACTED]) and [REDACTED] have arranged for the assignment of the existing mortgages held by [REDACTED] "to related entities of the general partner or [REDACTED] and/or other persons or entities."

On [REDACTED], a Purchase Agreement was entered into

between [REDACTED] and [REDACTED] for the sale of the [REDACTED] property to the latter partnership. The purchase price was \$[REDACTED], satisfied by the purchaser taking title to the property subject to the [REDACTED] mortgages, as modified by the Certificate of Reduction, and the payment of \$[REDACTED]. The agreement provided that the obligations of the purchaser are conditional on the mortgages having been restructured in a principal amount not to exceed \$[REDACTED] pursuant to the Certificate of Reduction.

The Certificate of Reduction, dated [REDACTED], consisted of a certification by [REDACTED] that the principal amount remaining due and unpaid upon the notes secured by the original [REDACTED] mortgage was limited to \$[REDACTED] with interest due after said date, all interest previously due being forgiven. The original mortgage was stated to be a lien on the premises covered thereby only to the extent of said principal and interest.

The Certificate of Reduction was expressly made conditional on the sale of the notes secured by the original mortgage to [REDACTED] and its partners provided additional assurances to [REDACTED] that if the sale of the [REDACTED] debt to [REDACTED] did not take place, [REDACTED] indebtedness to [REDACTED] in the original amounts would be reinstated and the original security restored.

Pursuant to a "Closing Agreement" dated as of [REDACTED] between [REDACTED] and [REDACTED], [REDACTED] sold to [REDACTED] the promissory notes and mortgages incurred by [REDACTED]. The purchase price for the debt was \$[REDACTED] cash. The mortgages were stated at full purchase price, "affected" by the Certificate of Reduction by [REDACTED] reducing the outstanding principal amount of the consolidated debt to \$[REDACTED] recorded immediately prior to the recording of the sale.

Although [REDACTED] was not a party to the Closing Agreement, it stated that [REDACTED] requested that [REDACTED], "as an accommodation" to it, reduce the face amount of the debt to \$[REDACTED], prior to or simultaneously with the consummation of the sale, and that the purchaser of the debt consented to such request. There was no consideration paid for the purported "accommodation." [REDACTED] agreed to indemnify and hold [REDACTED] and its participating lenders harmless from any claims arising from the sale of the note, the accommodation, (Certificate of Reduction) or any real estate transfer taxes.

In the Purchase Agreement between [REDACTED] and [REDACTED], [REDACTED] indemnified [REDACTED] from the liability guaranteed by [REDACTED] under the Closing Agreement. [REDACTED] entered into a Collateral Assignment and Pledge Agreement and a Guaranty with respect to [REDACTED]'s obligations to [REDACTED] and to [REDACTED] under

) the purchase agreement. In the Guaranty, [REDACTED] and [REDACTED] agreed that simultaneously with the execution of the guaranty, [REDACTED] is entering into an agreement with [REDACTED] to purchase the mortgages encumbering the property, and that the indemnification to [REDACTED] in the purchase agreement was made in order to induce [REDACTED] to enter into the transactions contemplated by the Closing Agreement with [REDACTED] and that [REDACTED] would not have entered into it without the assurances that [REDACTED] would provide the assurances and guarantees set forth in the guaranty.

On its [REDACTED] partnership return of income, [REDACTED] reported the sale of the land and the reduction of debt as two separate transactions. It reported the sale of the land as follows:

Cost of Goods Sold:		\$ [REDACTED]
Cost of Land:	\$ [REDACTED]	
Development Costs:	\$ [REDACTED]	
Commissions:	[REDACTED]	
	\$ [REDACTED]	
Gross Sales price:		
Sale of Land:	\$ [REDACTED]	\$ [REDACTED]
Land condemned:	[REDACTED]	
Rent income:	[REDACTED]	
Water income:	[REDACTED]	
	\$ [REDACTED]	
Gross Profit:		(\$ [REDACTED])

The Partnership reported as a schedule M-2 adjustment (adjustments to Partner's capital accounts) discharge of indebtedness income in the amount of \$ [REDACTED] consisting of the following:

Face amount of debt:	\$ [REDACTED]
Accrued deferred interest:	[REDACTED]
real estate taxes paid by bank:	[REDACTED]
	\$ [REDACTED]
Less: fair market value of property:	(\$ [REDACTED])
Cancellation of Debt Income:	\$ [REDACTED]

The primary partner, [REDACTED], excluded from his taxable income \$ [REDACTED] as a section 108(a)(1)(D) exclusion (debt was qualified real property business indebtedness.)

Analysis

The primary issue in this case is whether above described debt reduction is properly characterized as discharge of indebtedness income or gain from the sale or exchange of property. As explained below, the resolution of this issue turns on whether the debt reduction is separate and apart from the sale of the property, as maintained by the taxpayer. If, instead, the debt reduction is part of the proceeds from the sale of the property, then the partnership must recognize the debt reduction as gain from the sale of trade or business property under I.R.C. § 1231.¹

Section 61(a) of the Internal Revenue Code provides that gross income includes all income from whatever source derived, including "gains derived from dealing in property" under I.R.C. § 61(a)(3) and "income from discharge of indebtedness" under I.R.C. § 61(a)(12). In distinguishing between a sale or exchange and discharge of indebtedness, the courts have interpreted "sale or exchange" broadly and have interpreted "discharge of indebtedness" narrowly. Slavin v. Commissioner, T.C. Memo. 1989-221 and cases cited within.

I.R.C. § 1001(a), which governs the computation of gains from dealings in property, provides that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided." I.R.C. § 1001(b) defines "amount realized" as "the sum of any money received plus the fair market value of the property (other than money) received." The amount realized on a sale or disposition of property includes the amount of the liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. §1,1001-2(a)(1); Commissioner v. Tufts, 461 U.S. 300, 306 (1983).

In the case of a property encumbered by nonrecourse

¹For the reasons set forth, infra, we believe the debt reduction should be characterized as gain from a sale or exchange. [REDACTED] contends that the income is discharge of indebtedness income and that the exclusion from income provided by I.R.C. § 108(a)(1)(D) for qualified real estate indebtedness applies. He therefore reduced the basis in his assets under section 108(c)(1)(A). Based on our review of the facts, it appears the exclusion would have applied if the gain had qualified as discharge of indebtedness income. We express no opinion as to whether the taxpayer properly computed the basis reduction that otherwise would have applied pursuant to I.R.C. § 108(c).

indebtedness, the amount realized on disposition includes the entire amount of the mortgage on the property. Tufts, 461 U.S. at 312. See also Treas. Reg. §1.1001-2(c), Example (7). The fact that the fair market value of the security at the time of sale or disposition is less than the amount of the liabilities it secures "does not prevent the full amount of these liabilities from being treated as money received from the sale or other disposition of the property." Treas. Reg. §1.1001-2(b); Tufts, 461 U.S. at 310.

Section 61(a)(3) applies when a taxpayer agrees to surrender the property in exchange for the cancellation of a debt. Under this scenario, the transaction may be characterized as a sale or exchange of property giving rise to income under § 61(a)(3) with the whole amount of the canceled nonrecourse indebtedness being includable in the amount realized under § 1001. Therefore, §61(a)(3) applies if the transaction: (1) relieved the taxpayer-owner of his obligation to repay the debt, and (2) the taxpayer is relieved of title of the property. Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1982). In that case, the Court held that an abandonment qualified as a sale or exchange notwithstanding the absence of a counterparty offering a quid pro quo in exchange for the property, because of the presence of the two described events. The Court ruled that if the substance of the transaction was a sale under these criteria, the taxpayer's attempts to structure the form of the transaction to avoid this result would not be respected.

In 2925 Briarpark Ltd. v. Commissioner, 163 F3rd 313 (5th Cir. 1999), the bank holding a nonrecourse mortgage on partnership property agreed to cancel its note and mortgage on the property if the property were sold to a specified buyer for a specified amount of cash, with the partnership forwarding the sales proceeds and certain additional amounts to the bank in satisfaction of the debt. The partnership argued that the difference between the face amount of the debt and the cash received constituted discharge of indebtedness income. The court rejected this argument, holding that the full amount of the nonrecourse mortgage constituted gain from the sale under I.R.C. § 61(a)(3) and not discharge of indebtedness income. It held that a transaction will be subject to section 61(a)(3) and not 61(a)(12) if the debt reduction is in connection with the transfer of property. Under the facts of that case, the partnership's ability to dispose of the property was conditioned upon the relief of its debt, and thus was "closely intertwined" with the property transfer. Thus, the transaction was the functional equivalent of a foreclosure sale, and the fact that the buyer of the property did not assume the debt did not preclude this characterization.

The instant transaction is similarly "the functional equivalent of a foreclosure sale." In this case, as in Briarpark,

) the bank agreed to accept a reduced amount in satisfaction of the debtor's obligation, the buyer of the property conditioned the purchase on the reduction of the debt, and the debtor/seller was relieved of the full amount of the obligation at the same time as it transferred the property.

The taxpayer may argue that the debt reduction was in connection with the sale of the note, not the land, and that the note was reduced as an "accommodation" to [REDACTED], as stated in the sale agreement. However, that was not the substance of the transaction. First of all, the two sale transactions were closely intertwined. They were done simultaneously and the documents reflect the understanding of the parties that they were interrelated steps in a single transaction.

Second, in substance, the debt was reduced as an accommodation to the buyer, not [REDACTED], and facilitated the sale of the land. Given the contemplated sale of the property, [REDACTED] would have been indifferent to the reduction of the face amount of the debt. The sale would have relieved [REDACTED] of liability for the nonrecourse debt whether or not the face amount was reduced. (See, Treas. Reg. § 1.1001-2(a)(4)(i)). On the other hand, the purchase of the land by the buyer was expressly conditioned on the reduction of the debt, as the land buyer purchased the property subject to the mortgage, and thus would have wanted the face amount of the debt to be as small as possible.

Third, the taxpayer's assertion that the note purchaser agreed to give up the right to receive over \$ [REDACTED] in potential profit by the reduction of the face amount of the note to accommodate [REDACTED] is highly implausible. The note purchaser had no prior relationship to [REDACTED], and thus would not have reduced the value of the property it purchased, the note, on its behalf. On the other hand, the note purchaser had a [REDACTED] interest in the land purchaser, and therefore had an interest in reducing the latter's mortgage.

Thus, the reduction of the note was not an "accommodation" to [REDACTED] but to the land purchaser who purchased the property subject to the debt. The substance of the transaction is thus no different than if the note purchaser had loaned the funds to the buyer who used them to pay off the bank and purchase the property.

As in Briarpark, the partnership was simultaneously relieved of its obligation to pay on the note and relieved of its title to the property. As the Court found in Yarbro, the taxpayer cannot avoid gain recognition by structuring the transaction contrary to its substance. Therefore, the amount of the debt reduction is properly included in the gain from sale or exchange.

Please direct any questions to [REDACTED] at [REDACTED]
[REDACTED].

[REDACTED]
Area Counsel
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By: _____

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Associate Area Counsel
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cc: [REDACTED]